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German Tax and Legal News

Federal Constitutional Court rules change-in-ownership rules partially unconstitutional

In a taxpayer-favorable decision issued on 29 March 2017 and published on 12 May 2017, Germany's Federal Constitutional Court held that the change-in-ownership rules relating to loss carryforwards partially infringe the German constitution, and must be amended with retroactive effect. The taxpayer in the case initiated the proceedings in 2011 (see GTLN dated 27 May 2011).

Under the change-in-ownership rules, net operating loss carryforwards, interest carryforwards and current year losses are forfeited if there is a "harmful change in ownership." A direct or an indirect transfer of more than 25% (and up to 50%) of the shares in a company that has loss carryforwards results in a pro rata forfeiture of the carryforwards, and a share transfer of more than 50% results in a complete forfeiture of all available tax loss carryforwards. There are three exceptions to the loss forfeiture rules: (i) the intragroup restructuring exception; (ii) the built-in-gains exception (both applicable as from 2010); or (iii) the business continuation clause (applicable as from 2016).

The case before the Constitutional Court involved a direct share transfer of between 25% and 50% that resulted in a partial forfeiture of the tax loss carryforwards of the company. The court concluded that the rules violate the principle in the constitution that companies should be taxed on their financial performance. The legislative intent to prevent loss trafficking by using empty loss companies may be an acceptable justification for an exception from this principle, but a partial loss forfeiture of loss carryforwards where there is a change in shareholders of 25% and 50% is considered too broad and cannot be used to deem the taxpayer's behavior to be abusive.

It should be noted that the Constitutional Court restricted its decision to transfers of between 25% and 50% of a company's shares (section 8c (1) sentence 1 of the Corporate Income Tax Code (CITC)). The court did not provide any opinion on the constitutionality of the rule resulting in a full forfeiture of loss carryforwards following a transfer of more than 50% of the shares (section 8c (1) sentence 2 CITC).

The court also clarified that the introduction of the intragroup restructuring and the built-in-gains exceptions to the change-in-ownership rules does not affect its analysis. However, the court noted that the introduction of the business continuation clause (section 8d of the Corporate Income Tax Code (see GTLNs dated 6 September 2016 and 19 December 2016) as from 1 January 2016 potentially could change its analysis and, therefore, limited the scope of its decision to the period 1 January 2008 through 31 December 2015.

The Constitutional Court has asked the German legislature to draft and implement an amended change-in-ownership rule that is in line with constitutional principles by 31 December 2018. This rule should apply retroactively for the period 1 January 2008 until 31 December 2015. If the rules are not amended within this timeframe, the change-in-ownership rules as regards ownership transfers between 25% and 50% of the shares in a company will become automatically void on 1 January 2019 for the 2008-2015 period.

The following points of the Constitutional Court's decision are notable:

- The decision applies only to section 8c (1) sent.1 CITC (ownership transfers between 25% and 50%); the court did not decide on whether section 8c (1) sent. 2 CITC (ownership transfers of more than 50%) also violate constitutional principles, so the decision will not have any impact on the latter transfers. However, a separate procedure on section 8c (1) sentence 2 CITC currently is pending before the federal tax court.
- The decision only has effect for the period 1 January 2008 through 31 December 2015 and should apply for both corporate income tax and trade tax purposes.
- The decision did not address whether the change-in-ownership rules are in line with constitutional principles following the introduction of the business continuation

clause, which require a different analysis.

- Tax assessment notices that became final in the period 2008 to 2015 and that are not considered preliminary pending a decision of the Constitutional Court should not be able to be amended based on the decision of the court. Only tax assessment notices that still are open may be affected.

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